INTERCOMPANY TRANSACTIONS IN RELATION TO CONSOLIDATED INCOME STATEMENTS

by

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INTRODUCTION

Consolidated statements are accounting reports presenting the financial position and results of operations for a group of affiliated companies. It is a generally accepted rule that if a company is more than 50 per cent owned, it is consolidated into the results of the majority owner or parent company. It is also a generally accepted rule that a parent-subsidiary relationship exists whenever one company acquires a controlling interest in the voting stock of another company.

A subsidiary is a separate enterprise with its own capital structure, earning capacity, and record-keeping system. The stockholders, creditors, and other interested parties should be aware of this fact. Consolidated statements are additional reports prepared as a supplement to the separate "legal entity" statements of the individual members of the economic family. In some respects, then , a consolidated statement is a legal fiction and consolidating procedures (adjustments, eliminations, worksheets, etc.) are not real, but are convenient operational devices. The earnings of the subsidiary are not the earnings of the parent and the assets of the subsidiary are not available to meet claims of creditor's of the parent. The justification for consolidated statements is then the operating objectives of the affiliation.

The elimination of intercompany transactions are treated in advanced accounting textbooks not as a single topic, but as individual components of different chapters and topics. They

are not presented as a separate topic, but as elements of other subject matter areas. Consolidated statements involve many presentation problems per se, which in the ordinary course of study are difficult to comprehend. This situation tends to place less emphasis on the elimination of intercompany transactions than desired. However it is not the purpose of this report to stress these problems but rather to consider intercompany transactions in relation to consolidated income statements as one subject matter area and to report on the methods for their elimination.

PURPOSE OF CONSOLIDATIONS

When two or more corporations operate independently, they are viewed as separate legal entities. One corporation may gain control of other corporations by acquiring a majority of their stock. This control may be either direct or indirect. A direct control is acquired when a corporation owns 50 per cent of the voting stock of another company. The company being controlled is known as the subsidiary and the company doing the controlling is known as the parent company. If Company P owns controlling interest in the voting stock of Company A, and Company A owns controlling interest in the voting stock of Company B, Company P is said to have an indirect control of Company B. For example, if Company P owns 90 per cent of the voting stock of Company A, which in turn owns 90 per cent of the voting stock of Company B, then Company P is clearly able to elect a majority of the board of directors of Company A and, through Company A, to control the board of Company B.

When control is exercised over subsidiaries by a parent company it is desirable to show these companies as if they were operating as one entity. This is accomplished by consolidating their financial activities into one set of statements. The consolidated statements will reflect the activities as if it were only one economic entity.

In the absence of special circumstances, consolidated statements have become the common practice of stating the financial position and results of operations for a group of affiliated companies. The consolidated data should reflect the assumption that they represent a single business entity.[1]

The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.[2] There is a presumption that consolidated statements are more meaningful for a fair presentation when one of the companies in the group has a direct or indirect controlling financial interest in the other companies.

The basic premise which underlies the preparation of consolidated statements is that the affiliated companies are managed as

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[1]Committee of Concepts and Standards. "Consolidated Financial Statements." The Accounting Review, April 1955, p. 194.

[2]Committee on Accounting Procedure. "Consolidated Financial Statements." The Journal of Accountancy, Oct. 1959, p. 73.

one economic entity and that financial statements similar to those customarily prepared for an accounting unit fairly present the financial position and results of operations of the consolidated economic entity. However the unique interdependence of affiliated companies sometimes introduces additional limitations. For example, since all transactions between affiliated companies may not be conducted at arm's length, the statements of the individual companies must be interpreted carefully and in conjunction with each other and with the consolidated statements. It is not possible to tell which companies are making money from looking at consolidated statements. A consolidated net income figure may be misleading. It may be that the earnings are being contributed by a few companies and the balance in the group may be operating at a loss. There is no way of telling which companies in the group are providing the earnings unless the separate statements are available.[3]

With the growth of interrelated companies, there has developed a greater need for a better picture of the entire system. The consolidated balance sheet and consolidated income statement have been created to fulfill this need. Since in such cases the interests of most of the parties concerned are identified primarily with the financial welfare of the entire system, the statements which will disclose the financial position and earnings of

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[3]Percival F. Brundage. "Some Shortcomings in Consolidated Statements." Journal of Accountancy, Oct. 1930, p. 290.

the system as a whole are indispensable.[4] Consolidated statements disregard, or minimize, legal lines of cleavage and stress managerial unity. In such reports the overlapping, intercompany accounts are canceled and a picture is drawn of the affiliation, the family of companies, in its over-all relation to the external business community.[5]

In order to show the details of the manner in which the consolidated earnings of the affiliated corporation arose, as generally accepted by accountants, a consolidated income statement is prepared.[6] All transactions between constituent companies are eliminated. The remaining balances will then represent the results of transactions with legal persons outside the group. The net profit accruing to stockholders is then apportioned to controlling and minority interests. In the preparation of consolidated statements, the usual practice is to eliminate the estimated amount of intercompany gain which has not been finally consummated by transactions with parties outside the affiliation.[7] However, before the consolidated statements are prepared a uniformity in records has to be established. This is necessary since

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[4]Thomas Henry Sanders, Henry Rand Hatfield and Underhill Moore. Statement of Accounting Principles, p. 101.

[5]William A. Paton. Advanced Accounting, p. 573.

[6]Sidney I. Simon. "Consolidated Statements and The Law." The Accounting Review, Oct. 1953, p. 506.

[7]Edward A. Kracke. "Consolidated Financial Statements." The Journal of Accountancy, Dec. 1938, p. 386.

the consolidated records will reflect the group of companies as one entity. The parent and subsidiary company do not necessarily have the same account titles and descriptions. The accounts will have to be evaluated and classified according to their reciprocity.[8]

The elimination of the financial effect of intercompany transactions, with the exception of intercompany profits in inventories and fixed assets when 100 per cent is eliminated from a subsidiary vendor, does not affect the computation and disclosure of the minority shareholders' interest in a subsidiary company. In fact, the elimination of these items does not affect the net amount of the majority's interest because the items are reciprocal and cancel out. The elimination or canceling out of these intercompany transactions simply prevents a padding of items in the consolidated statements.

There are several intercompany transactions which must be considered in relations to the consolidated income statement. These intercompany transactions must be eliminated in order that the income statement will reflect the results of operation for the affiliation as one economic entity.

Intercompany transactions and their relation to the consolidated income statement will be discussed in this report.

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[8]Walter A. Holt. "Accounting Problems of Mergers and Consolidations." N.A.C.A. Bulletin, Sept. 1956, p. 136.

INTERCOMPANY TRANSACTIONS IN RELATION TO CONSOLIDATED INCOME STATEMENTS

Parent and subsidiary accounting is only one of many tools available to management. Consolidated statements minimize the separate "legal entity" statements and stress managerial unity through consolidation. The essential purpose of consolidated statements is to display the income records and financial position of two or more affiliated companies as if they were one company.[9] Consolidated statements are essential to management and investor, to provide a bird's-eye view of the activities of a going concern. Most of the difficulties involved in consolidated statements relate to a misconception of the purpose which they seek to accomplish. The theory behind these statements is that they should present an aggregate picture of an affiliation as if it were one economic unit.[10]

The reasons for affiliation between parent and subsidiary will vary within the separate organizations. Companies which produce raw materials may be acquired to assure a steady flow of such material at a favorable price. The subsidiary may be acquired to enhance the parents position in a competitive field. The rules of the Securities and Exchange Commission as reflected in the Securities Act of 1933 represent another reason for having

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[9]Paton, _op. cit._, p. 751.

[10]Victor H. Stempf. "Consolidated Financial Statements." _The Journal of Accountancy_, Nov. 1936, pp. 364,5.

consolidated statements. This act gave the Federal Trade Commission discretionary powers to call for consolidated statements in the regulation of new security issues.[11] The rules of the New York Stock Exchange specify requirements similar to the SEC regulations calling for the parent and each subsidiary or consolidated statements of the group.

There are multiple reasons for acquisitions; however in consolidated reports the intercompany accounts are eliminated and a picture is drawn of the aggregate enterprise in its relations to the external business community.

INTERCOMPANY INTEREST, RENTS, FEES, BONDS, ETC.

Interest, rents, fees, bonds, etc. must be recognized by the individual companies when each is recognized as an independent entity and must be included in its income statement. In preparing a consolidated income statement for two or more affiliated companies these items must be eliminated. The consolidated net income figure would not be affected by this elimination because where one company would show the amount as an income item the affiliate would show it as an expense. These items are eliminated in order to show the affiliated companies as one economic entity, and this is accomplished by eliminating the reciprocal accounts of the affiliates. All intercompany income should be eliminated in preparing a consolidated income

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[11] Louis H. Rappaport. SEC Accounting Practice and Procedure, p. 4.

statement. If bonds or notes payable of affiliates are held by parties to the affiliation, the interest income of the creditor company from this source will be canceled against the corresponding interest charge of the debtor. Rental papments from one affiliate to another, royalties, and fees of any sort are likewise set off against each other and eliminated from the income statement.[12]

Intercompany bond transactions are used to illustrate the typical elimination for intercompany interest, rents, fees, bonds, and other related transactions.

Elimination of Intercompany Bond Transactions:

If the Parent Company (P) holds bonds of the Subsidiary Company (S) the intercompany bond holdings should be eliminated. The intercompany interest income and interest expense should also be eliminated. The consolidation problem is one of offsetting the asset account of the bondholder against the liability account of the issuer. The intercompany held bonds are essentially treasury bonds and from the standpoint of the consolidated group should be treated as such. The following represent the applicable entries:

Bonds Payable - Company S	$100,000	
Bonds of Company S - Company P		$100,000
To eliminate intercompany bond holdings		

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[12] Rufus Wixon. <u>Accountants Handbook</u>, p. 23-47.

Interest Income - Company P (Creditor)	$5,000	
Interest Expense - Company S (Debtor)		$5,000
To eliminate intercompany interest income and interest expense		

The above illustration assumed that the bonds were acquired at par; therefore no unusual problem is encountered. When bonds are not bought or sold at par the intercompany accounts may not be reciprocal. When this condition exists, reciprocity must be established before eliminating the asset account against the liability account. The following problem will illustrate the procedure for elimination when bonds are reacquired from sources other than the affiliation.

Elimination of 100 per cent

Company P owns 90 per cent of the stock of Company S. Company S has outstanding $100,000 of bonds with an unamortized premium of $3,000. Company P purchases $50,000 of the bonds from outsiders for $49,000 or at a $1,000 discount. The gain on reacquisition of the bonds may be computed as follows:

	Total	Outstanding	Reacquired
Maturity value	$100,000	$50,000	$50,000
Premium	3,000	1,500	1,500
Book value	$103,000	$51,500	$51,500
Cost of bonds reacquired by P			49,000
Gain on reacquisition			$ 2,500

The worksheet elimination assumes that the gain was made by Company P and that the $2,500 gain accrues to Company P stockholders. The elimination would be as follows:

Premium on Bonds Payable	$1,500	
Bonds of Company S	1,000	
Gain from Reacquisition of Bonds - Company P		$2,500
To reflect gain from reacquisition		

The consolidated working paper should reflect the entries as follows:

Debits	Co. P	Co. S	Adjustment & Elimination Dr.	Adjustment & Elimination Cr.	Consolidated Financial Statement
Bonds of S	$49,000		$1,000 A		$50,000
Credits					
Bonds Payable		$100,000			100,000
Premium on Bonds		3,000	1,500A		
Retained Earnings: Co. P				$2,500 A	

Assuming that the 100 per cent elimination is to be shared between the consolidated retained earnings and a minority interest. The minority interest being 20 per cent. The elimination would be as in the preceding illustration except a minority interest of 20 per cent should be reflected as shown in the following entry.

Premium on Bonds Payable	$1,500	
Bonds of Company S	1,000	
Retained Earnings - Company P		$2,000
Retained Earnings - Minority Interest		500
To reflect gain to Co. P and also in minority earnings.		

INTERCOMPANY BAD DEBTS

Bad debt amounts arising from intercompany debts should be eliminated. If the charges for bad debts expense and the corresponding allowance for uncollectibles are not scrutinized carefully to determine the amount arising from intercompany debts, the consolidated profit will be understated due to the lack of the elimination of the expense and the allowance for uncollectibles. The allowance account in the balance sheet would also be overstated if the amount allocable to the intercompany allowance is not removed. Since the debtor-creditor relationship between affiliates is eliminated in total in a bonsolidated balance sheet, a charge for bad debts in an income statement has no meaning for the group viewed as a unit. Whether individual affiliates pay or do not pay intercompany debts has no effect on consolidated income or net assets. Although the use of an allowance for uncollectible intercompany accounts is undesirable, when such a provision is found an adjustment is made on the consolidated working papers debiting the allowance for uncollectibles and crediting bad debt expense of the creditor company.[13] The working paper entry would appear as follows:

Allowance for Uncollectibles - Co. P	$150	
Bad Debt Expense - Creditor Co. S		$150
To eliminate intercompany allowance for uncollectibles from consolidation		

[13] *Ibid.*, p. 23-48.

INTERCOMPANY SALES OF ASSETS

What should be done with the intercompany markup in assets which remain on hand by the purchasing affiliate at year end? The American Accounting Association in its Accounting and Reporting Standards for Corporate Financial Statements recommend the following:

> In the consolidated financial statements, no gain or loss should be recognized as the result of transactions among affiliates. From a combined point of view, these transactions result merely in a shift of assets from one department or branch to another department or branch of the same entity. Therefore:
>
> 1. The elimination of intercompany markups in assets should be complete, irrespective of the presence or absence of an outside (minority) interest. This procedure is necessary to insure a cost basis which, properly should not be affected by the pattern of share ownership.
>
> 2. The amount of intercompany markup to be eliminated is the intercompany gross margin reduced by any inventoriable costs incurred in the movement of the goods from one affiliate to another.
>
> 3. The intercompany gain to be eliminated from assets logically is applied in consolidation as a reduction of the income or retained earnings of the affiliates that have recorded the gain. If any such affiliate is a subsidiary with a minority interest, the per share equity of that interest is thus reduced, in the consolidated statements, in the same manner and in the same proportionate amount as the controlling interest. The practice of reflecting a minority interest's share of unrealized intercompany profit as if realized, while widely accepted, conflicts with the underlying purpose of consolidated financial statements as herein contemplated, namely, to reflect the activities of a group of companies as though they constituted a single unit.[14]

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[14] American Accounting Association. Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, p. 45.

In the preceding quotation, the American Accounting Association describes the way intercompany profits in assets should be handled. There are several methods of handling intercompany profits in assets which will be considered within each intercompany transfer listed below.

INTERCOMPANY SALES OF MERCHANDISE

If the inventories remain within the affiliated group no profit has been realized as evidenced by a sale to outsiders, consequently we must eliminate the intercompany markup or profit included in the reports of the affiliated companies.[15] The elimination of intercompany sales has the effect of leaving as a remainder a consolidated sales figure which represents the results of transactions with outsiders. Since an intercompany sale will show as a purchase on the vendee's books, the cancellation can usually be performed without difficulty. An examination of the records of the constituent companies is necessary in order to make sure that all intercompany transactions have been completely recorded. By eliminating the intercompany sales with purchases, the whole transaction is erased as though it had never occured. The intercompany profit along with the sale, included in the sales figure, is eliminated. The problem arises when some of the intercompany merchandise remains on the books of the vendee company at year-end. The profit included in this year-

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[15] Maurice Moonitz. "The Entity Approach to Consolidated Statements." <u>The Accounting Review</u>, July 1942, pp. 238,9.

end inventory must also be eliminated because it has not been realized in the consolidation. The elimination of the unrealized profit in the beginning and ending inventories result in a consolidated cost of goods sold which includes only the cost of goods sold to outsiders. Failure to eliminate the unrealized profit from the beginning inventory will overstate the cost of goods sold and understate consolidated net income. If the unrealized profit remaining in the ending inventory is not eliminated the consolidated cost of goods sold will be understated and profits overstated. Therefore, the computation of consolidated cost of goods sold and of consolidated gross profit is closely related to the problem of inventory valuation. The consolidated cost of goods sold is computed by taking the combined cost as shown by the books of the constituent companies less intercompany purchases plus or minus adjustments of inventory figures. The consolidated working paper should reflect the following entries when there is intercompany profit in merchandise in the beginning and ending inventories:[16]

Cost of Goods Sold	$10,000	
Inventory		$10,000
To eliminate intercompany profit in ending inventory		
Retained Earnings	$10,000	
Cost of Goods Sold		$10,000
To eliminate intercompany profits in beginning inventory		

[16]Kracke, *op. cit.*, p. 386.

There are other situations that might arise with intercompany sales of merchandise. One situation occurs with market write-downs and intercompany profit deductions. If the inventory valuation of merchandise acquired from an affiliated company has been reduced from cost to market and the amount of the reduction is the same or greater than the reduction that would have been made for intercompany profit then no further reduction in the inventory valuation need be made. If the market write-down was less than the intercompany profit a working paper adjustment is made only for the intercompany profit not eliminated. An other situation occurs when there are intercompany sales at a loss. If consistency is to be maintained with the elimination of intercompany profits, it follows that the inventories should be increased by the amount of intercompany loss.[17]

INTERCOMPANY SALES OF FIXED ASSETS

When fixed assets are transferred between affiliated companies, there arises a need to eliminate, on the consolidated working papers, any profit that the vendor has recorded on his ledger and any of this profit that has found its way into the consolidated retained earnings which is considered to be unrealized.

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[17] Committee on Accounting Procedure. "Consolidated Financial Statements." Accounting Research Bulletin No. 51, pp. 42,3.

There are two methods of eliminating intercompany profits on fixed assets. The first method is the elimination of one-hundred per cent of the vendor's profit. This method assumes that the cost to the selling company is the cost to the consolidation. In the year in which a fixed asset is bought and sold within the affiliation the simplest procedure is to reverse on the working papers the effect of the sale in terms of the selling company's accounts and to credit the consolidated fixed asset account for the unrealized profit margin. The entry on the working paper would be as follows:

Gain on Sale of Assets - Co. S. (Selling)	$2,000	
Fixed Asset Account - Co. P (Purchasing)		$2,000
To eliminate intercompany profit in fixed assets		

In the above hypothetical entry the asset acquired by Company P from Company S is reduced to cost and the profit reported by Company S is eliminated.

The elimination of intercompany profit in assets can be further complicated when assets subject to depreciation or amortization are bought and sold between parent and subsidiary or between one subsidiary to another. Assets acquired from another company in the group may reflect realized profit for the selling company; therefore an adjustment is required to eliminate the profit element. Assume that an asset is sold for $50,000 which includes a profit of $10,000 or 20 per cent intercompany profits. The asset has an estimated useful life of 10 years and is being depreciated on a straight-line basis. Three situations will be

considered: (1) Consolidation in the year of sale, (2) the consolidation one year after sale, and (3) the consolidation two years after sale.

Sale by Parent to Subsidiary

1. Consolidation immediately after sale.

Gain on Sale of Asset - Co. P	\$10,000	
Asset Account - Co. S.		\$10,000

To eliminate intercompany profits.[18]

2. Consolidation one year after sale.

Retained Earnings - Co. P	\$10,000	
Allowance for Depreciation - Co. P	1,000	
Depreciation Expense - Co. S		\$ 1,000
Asset Account - Co. S		10,000

To eliminate intercompany profit.[19]

3. Consolidation two years after sale.

Retained Earnings - Co. P	\$ 9,000	
Allowance for Depreciation - Co. S	2,000	
Depreciation Expense - Co. P		\$ 1,000
Asset Account - Co. S		10,000

To eliminate intercompany profit

Each year on the consolidated working papers, depreciation expense must be credited for the difference, and the proper allowance fro depreciation must be debited an equal amount.

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[18] The percentage ownership of the parent is not considered. The adjustment is made for the full amount of the profit.

[19] The adjustment removes the 20 per cent profit element.

Each year the carrying value of the fixed assets must be adjusted from the net figure which equals cost to the vendor less accumulated depreciation thereon. Each year, since the working papers are not automatically continuous, fixed assets must be credited on the working papers for the initial unrealized profit margin, the allowance for depreciation must be debited for the difference between depreciation on cost and per the vendee's books accumulated to the first of the year, and consolidated retained earnings must be debited for the balance. The profit element in the year of sale must also be eliminated.[20]

The second method assumes that the cost to the consolidated entity is the cost to the vendor plus the profit of the vendor applicable to its minority. Only the parent company's share of the intercompany profit is eliminated from consolidated profits. This is true because only the parent company's share of the reported intercompany profit is carried to the consolidated profits and retained earnings. In following years the annual depreciation charge to the consolidated entity is based upon the sum of the cost to the vendor plus the profit applicable to the vendor's minority interest.[21]

The eliminating entry for the profit or loss must be

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[20] Moonitz, _op_. _cit_., p. 239.

[21] Stempf, _op_. _cit_., pp. 368,9.

reduced by depreciation since the date of transfer and any excess depreciation over that normally taken by the transferor must be reckoned with and eliminated every year.[22] During the service life of the fixed asset, the vendee will usually include in its income statement a charge for depreciation expense based on the purchase price. Since an intercompany profit was included in the purchase price, the depreciation figure will be too high for use in a consolidated statement. Consequently, depreciation will have to be recomputed on a basis of cost to the entire group and an entry made debiting allowance for depreciation and crediting depreciation expense. Thus, when fixed assets are transferred between companies at a profit, the depreciation expense, from the consolidation viewpoint, will have to be reduced; and if transferred at a loss, will have to be increased, since for consolidation purposes depreciation is based on cost to the original purchaser.[23]

In the writer's opinion intercompany sales between affiliated companies in reality are intercompany transfers which are made for the convenience of the consolidation. It follows that the practice of transferring depreciable property between the group must be carefully studied and reviewed in the future.

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[22] E. J. Erp. "Preparing Consolidated Statements for Management." Controller, Aug. 1953, p. 363.

[23] Wixon, op. cit., p. 23-46.

This is primarily because of the Revenue Act of 1962 which allows a 7 per cent investment credit for eligible property, or "Section 38 property," as defined under Section 48 (b) of the Internal Revenue Code of 1954. This investment credit was granted to help in the acceleration of the economy through encouragement of investments in productive facilities. The 7 per cent investment credit in, "Section 38 property," new and to a limited extent in used depreciable property excluding buildings may be subtracted from the tax liability.[24]

The problem is that intercompany transfers may result in the loss of the investment credit just as if the property were sold or otherwise disposed. The credit lost may be all or a portion because Section 48 (c) of the Internal Revenue Code makes it clear that the property transferred to the acquiring corporation does not qualify as used property under "Section 38 property." The property must be purchased as defined in Section 179 (d)(2). This section specifically excludes property acquired from within the affiliation. The problem of intercompany transfers of "Section 38 property" will affect groups where there is a common parent corporation. Where there is a group of brother-sister relationship, in an early transfer between them a loss of credit to the selling corporation may result,

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[24]Internal Revenue Service. "Special Supplement, 1963 Federal Tax Course, <u>The Revenue Act of 1962</u>, pp. 5-12.

however the acquiring corporation would be entitled to the credit based on "Used Section 38 property." Used property is subject to the limitation of $50,000 per year.

Section 48 (b)(2) requires that "Section 38 property" begin in use with the taxpayer in order to qualify. The company purchasing "Section 38 property" must use it. However if the company purchasing the property does not use it, but right after acquisition transfers it to some other company within the group, it will be mandatory to maintain accurate records to indicate that the purchasing company was actually a purchasing agent and that it did not use the property or that the property was new to the corporation for whom it was purchased. The transfer of Section 38 property within the affiliation must follow a consistent policy as specified in Section 48 (b)(2) or risk the loss of the investment credit applicable to that property transferred. Adequate records must be maintained to substantiate the special arrangements between the companies in the affiliation.[25]

INTERCOMPANY DIVIDENDS

Intercompany dividends are excluded from the consolidated income statement. The primary reason for the exclusion is that dividends represent neither income to the recipient nor an expense to the corporation making the payment. Dividends represent a distribution of profits and are not themselves an ele-

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[25] Wallace M. Jensen. "Tax Clinic", The Journal of Accountancy, March 1963, pp. 77,78.

ment in profit. Consequently duplication of income is avoided by eliminating intercompany dividends upon consolidation. A further reason for excluding dividends is that they are not based exclusively on the profits of the period in which they are declared or paid. Dividend declarations are based, legally, on the existence of certain types of surplus, usually retained earnings, which may have arisen as the result of transactions occuring in prior periods. Therefore, even if it is assumed that dividends come out of the profits most recently earned, they often exceed the income of the current period. To avoid this situation, only the underlying transactions of subsidiaries which result in a profit available for dividends are shown in a consolidated income statement. Dividends received from related companies which are not consolidated are included in the consolidated income statement if the recipient carries the investment account at cost. If the recipient's investment account is adjusted for changes in the book value of the underlying equity, then a dividend is credited to the investment account and appears neither in the income statement of the recipient nor in the consolidated income statement.[26]

MINORITY INTEREST IN EARNINGS

The consolidated net income figure which is apportioned between the controlling and minority interest is arrived at through

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[26]Wixon, op. cit., p. 23-50.

the elimination of intercompany income and expense items and intercompany profits.[27] The amount of consolidated income to allocated to the minority interest will depend on the methods used in eliminating intercompany profits. The American Accounting Association in its Survey of Consolidated Financial Statement Practices found that:

> Of the 60 companies which had minority interests, 33 per cent reported that they had the problem of intercompany profits made by the parent company. Thirty eliminated the profit entirely from the consolidated earned surplus, two eliminated only the portion corresponding to the parent company's interest in the subsidiary, and one, a meat packer, made no elimination because the inventories were valued at selling price less allowance for selling and distribution expenses.
>
> Nineteen companies indicated that intercompany profit had been made by subsidiary companies. Sixteen eliminated the entire amount from the consolidated earned surplus, one eliminated only the parent company's share, and two made a complete elimination but divided the amount between consolidated earned surplus and the minority interest.[28]

When the controlling interest's equity in intercompany profits is eliminated, the minority interest is credited with its share of the subsidiary's profit, unadjusted for intercompany profits. The remainder is then allocated to the controlling interest. When intercompany profit is eliminated a minority's interest in earnings is equal to its proportion of the net income of the individual company after adjustment

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[27] Simon, op. cit., pp. 512,3.

[28] American Institute of Accountants, Survey of Consolidated Financial Statement Practices, p. 17.

for intercompany profits. For example subsidiaries, Company S and Company T had net income of $20,000 and $30,000 respectively. These figures include a minority interest of 10 per cent in each subsidiary. The figures also represent intercompany profits of $1,000 and $2,000 respectively. The allocation should be made as follows:

Intercompany profits

Reported profit of Co. S		$20,000
Reported profit of Co. T		30,000
Total		$50,000

Controlling Co's equity in intercompany profits

Co. S = $1,000 x 90%	$ 900	
Co. T = 2,000 x 90%	1,800	(2,700)
		$47,300

Minority interest in consolidated net profit

Co. S = 10% of $20,000	$2,000	
Co. T = 10% of 30,000	3,000	(5,000)
Controlling interest in consolidated Net profit		$42,300

Dr. Moonitz presents an argument against the customary method of computing minority interest for consolidated statements if there are mutual holdings of capital stock. His contention is that stocks of a corporation held by its subsidiary should be treated as treasury stock and be deprived of its voting power as well as the right to share in dividends. Dr. Moonitz computation of minority interests is based on the assumption that shares of the parent company held by the subsidiary and an

equivalent amount of stock of the subsidiary held by the parent corporation do not share in dividends.[29]

The writer prefers the customary method as presented because the minority stockholders investment in a parent company is an investment of a part of their company net worth and could not be eliminated because the parent company had as large, or larger, investment in their company.

METHODS OF ELIMINATING INTERCOMPANY PROFITS

Three methods of eliminating intercompany profits will be considered. They are the cost method, the entity method and the equity method.

In the cost method the underlying assumption is that the assets transferred should be stated, for balance sheet purpose, in terms of the original cost to the first purchaser. In other words, the elimination entry on the working papers will not only accomplish the removal of unrealized profit, but will permit the asset account to be valued at cost for the balance sheet.

The entity method as advocated by Maurice Moonitz, Ph.D. recommends, in effect, that neither the parent company nor the subsidiary can realize a profit or loss on an intercompany transaction. Under this method all of the effects on all the ledgers of all the intercompany transactions which contain unrealized profits must be reversed. If the parent company made a sale to

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[29] Maurice Moonitz. "Mutual Stockholdings in Consolidated Statements." The Journal of Accountancy, Oct. 1939, pp. 227-35.

a subsidiary at a profit, then for consolidated purposes, under the entity method, the unrealized profit would have to be removed from the inventory account and also from the parent's retained earnings. If the subsidiary made a sale to the parent company and thereby realized a profit on its ledger, the profit increment must be eliminated from the inventory and from the subsidiary's earnings, and also the percentage of this profit that the parent company has recorded in its retained earnings must be eliminated.[30] For example, if the parent company has an 80 per cent interest in a subsidiary, it must eliminate 80 per cent of the unrealized profit which it has picked up as realized from the subsidiary. The simplest procedure to accomplish this on the working papers is to reverse the effect of the intercompany profit from both the vendor's and vendee's point of view.

Consolidated statements are traditionally parent company statements, with minority interests being virtually ignored except as an amount necessary to make the balance sheet balance. Those advocating the use of the "entity" theory recommend that the equity section of the balance sheet include the minority interest as "co-owners" of the enterprise.

The equity method advocates that all effects of an intercompany transaction on consolidated retained earnings must be eliminated. When only the parent company's share of the intercompany profit is eliminated from consolidated profits, the share

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[30] Moonitz, "Entity Approach," pp. 236-42.

applicable to the minority interest in the vendor is considered as earned by the minority. Under this method the consolidated working papers will actually recognize or realize part of the intercompany profit. Therefore, the consolidated profit arising from intercompany transactions will tend to be less than the profit recorded on the parent and subsidiary ledgers, but in an amount equal to the elimination. When this method is used, the inventory which is carried to the balance sheet is overstated by the amount of the profit not removed and recognized as realized.

Which of these methods is employed is a matter of the accountant's own discretion. If it is generally accepted that there is no increase in value when goods are transferred from one affiliate to the other, then it would seem logical on consolidations to eliminate the entire intercompany profit regardless of minority interests. This is the usual case, but there is by no means unanimity of opinion where it comes to allocating the elimination to the proprietary interests.[31]

The American Institute of Certified Public Accountants advocate the use of the entity method for intercompany profit eliminations. The Committee on Accounting Procedure set forth the following view:

> In the preparation of consolidated statements, intercompany balances and transactions should be eliminated. This includes intercompany open account balances, security holdings, sales and purchases, interest, dividends, etc. As consolidated statements are based on the assumption that they represent the financial position and operating results of a single business enterprise, such statements

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[31] John Peoples. "Preparation of Consolidated Statements..." The Journal of Accountancy, Aug. 1957, p. 34.

should not include gain or loss on transactions among the companies in the group. Accordingly, any intercompany profit or loss on assets remaining within the group should be eliminated; the concept usually applies for this purpose is gross profit or loss. However, in the regulated industry where a parent or subsidiary manufactures or constructs facilities for other companies in the consolidated group, the foregoing is not intended to require the elimination of intercompany profit to the extent that such profit is substantially equivalent to a reasonable return on investment ordinarily capitalized in accordance with the established practice of the industry.[32]

The Research Department of the American Institute of Certified Public Accountants conducted a survey to determine the opinion of accountants on the subject of elimination of intercompany profits. The accountants were asked to indicate whether they thought the eliminations should cover only the controlling interest equity in intercompany profits or should include the full amount. Those who replied were evenly divided in their reactions to this question. Several advocated eliminating the full amount of intercompany profits, apparently on the grounds that, as a practical matter, refinement is not necessary. One accountant favored elimination of the full amount of intercompany profits with the portion applicable to the minority purposes; others would eliminate the full amount, but in computing the minority interest would not reduce it to the extent of its share in intercompany profits.

Several accountants asserted that consolidated earnings and

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[32] Committee on Accounting Procedure. "Consolidated Financial Statements." Accounting Research and Terminology Bulletins 1961, pp. 42,3.

consolidated inventories should be reduced only by the portion of unrealized intercompany profits attributable to the controlling interest. The entire minority interest in the subsidiary's profit should then be deducted from consolidated profits in arriving at consolidated profits applicable to the controlling interest. To take out the entire unrealized intercompany profit and the minority's share of the subsidiary's profit, it was argued, would reduce the remaining consolidated net profit below that amount properly applicable to the controlling interest. Following this treatment, some portion of unrealized profit would remain in consolidated inventories, but this is as it should be since it represents cost to the consolidation.[33]

The elimination in connection with the consolidated financial statements present several additional matters for particular attention. The elimination in connection to intercompany sales and intercompany cost of sales exclusive of the adjustment of cost of sales for unrealized profit in inventories follow one or two procedures. In the first, sales are eliminated from the selling affiliate and purchases by the purchasing company are removed from the cost of sales. This method results in a mutual cancellation and there is no difference in net income. In the second, total intercompany sales are eliminated from sales, but instead of a similar elimination of purchases, it is the related

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[33]Research Department, American Institute of Certified Public Accountants. "Some Problems Regarding Consolidated and Parent Company Statements." The Journal of Accountancy, Nov. 1953, pp. 574,5.

amount of cost of sales as computed by the selling unit which is removed from the total cost of sales. This results in a difference representing the operating results as a profit or loss, depending on the circumstances. Separate adjustments are made in this case showing the difference in the consolidated report. The second method is used to show specific disclosure of the profit and loss attributable to certain activities of the business. This difference related to the entire amount of intercompany transactions during the period involved, inclusive of the profit or loss realized on the product finally included in consolidated sales to outsiders as well as products still on hand in the inventory of the purchasing affiliate.

The profit element in the ending inventories together with the effect of the related adjustment attaching to the opening inventories require adjustment in each of the two cases. These adjustments will affect retained earnings for the period. Aside from such consolidating adjustment for unrealized intercompany profits in inventories and in some cases property, other eliminations do not ordinarily affect the retained earnings for the period. There are excemptions in the case of intercompany payables where the selling company has not recorded the income because it has not been earned.[34]

From the many comments and reasons which were received from the survey in addition to other information available, it is

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[34]Kracke, op. cit., p. 386.

apparent that there is no one way to eliminate intercompany profit. As long as the reason underlying the method is sound, it can be deemed acceptable in consolidating.

SUMMARY AND CONCLUSION

For every corporation, regardless of its relation to other companies, there should be maintained a distinct system of accounts; and for every corporation, separate financial statements should be periodically prepared. Such accounts and statements, however, may not alsways be adequate to meet the requirements of managers and owners at the primary control level of a group of affiliated enterprises. Wherever there is an area of dominating ownership and administration there is likely to be need for showing operating performance and financial position for the group as a whole. Consolidated statements are designed to take care of this need.

The essential purpose of consolidated statements is to display the income record and financial position of two or more associated companies as if they represented a single enterprise. Consolidated statements minimize the separate "legal entity" and stress managerial unity. In such reports, the overlapping, intercompany accounts are canceled, and a picture is drawn of the affiliation in its over-all relation to the external business community.

The stockholders, creditors and other interested parties should understand the limitations of consolidated statements, particularly in view of the rapid acquisition of subsidiaries

and the indiscriminate use of such statements. The fact that a consolidated report does not reflect conditions of any distinct legal entity is also emphasized. Consolidated statements should be viewed as a supplementary device, not as a substitute for the conventional exhibits of the affairs of either the parent or the subsidiary companies. The stockholders and creditors of corporation are immediately concerned with the statements of their companies as an independent organization, and only secondarily with the joint picture of the affiliated companies. The earnings of the subsidiary are not the earnings of the parent and the assets of the subsidiary are not available to meet claims of creditors of the parent. This means that the practice followed by most large companies of publishing no statements other than the combined reports is unfortunate.

In the opinion of the writer the proper procedure in presentation of consolidated statements is to submit individual reports of all the companies in the affiliation. These reports should be substantiated by supporting details of the data used in their formulation. The consolidated working papers and exhibits should provide for columns showing the parent company's position; another column or as many columns as needed for the individual subsidiaries; another column to show the combined position of parent and subsidiaries; another column for adjustments and eliminations of intercompany transactions; and a final column to show the final total for the consolidation. This procedure would give a comprehensive picture of the financial and operating position of each individual company plus that of

the affiliation. If, however, the subsidiary companies are, in effect, merely departments of the parent company and their operating objective is only to facilitate the parent company operations, consolidated statements may be sufficient providing that intercompany transactions and profits are properly eliminated.

All intercompany transactions must be eliminated in order to show the affiliated companies as one operation. This affects the income statement by removing all intercompany nominal accounts and recognizes only transactions that were negotiated with outsiders during the period. The intercompany nominal accounts are reciprocal on the ledgers of the two affiliated companies; therefore one company has recorded an income, and an affiliate company has recorded the expense. If these reciprocal accounts were not eliminated, this would not affect the consolidated profit. This is because the income of one company would automatically be offset by the expense of the affiliated company. The only purpose for eliminating these accounts is to show, in the consolidated statements, only those transactions that have been entered into with outsiders; therefore, those transactions which appear to be conducted within the group of related companies must be eliminated. The unrealized profit remaining in the ending inventory of the vendee company, which arose through intercompany transactions, must also be eliminated in order to show only the profit realized through the sale to outsiders or to companies not affiliated with the group. Profit shown to have been realized on the sales of intercompany fixed assets must also be

eliminated. This is so because the affiliation cannot realize a profit on something that in fact sold to itself.

The effect of removing unrealized intercompany profits on the consolidated income statement is to show the net income realized only from transactions with outsiders. The removal of unrealized profits will tend to show a total consolidated profit of a lesser amount than merely the sum of the net income shown on each company's ledger before consolidation. Therefore, by removing unrealized profits and eliminating the intercompany nominal accounts from the consolidated income statement, the objectives of consolidation are accomplished. Consolidated net income reflects only amounts realized through transactions with outsiders. The several companies are reflected as a single entity operation and thus offer the needed information requested by management and stockholders of the parent or dominant company.

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INTERCOMPANY TRANSACTIONS IN RELATION
TO CONSOLIDATED INCOME STATEMENTS

by

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AN ABSTRACT OF A MASTER'S REPORT

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ABSTRACT

The purpose of this report is to consider intercompany transactions in relation to consolidated income statements as one subject matter area and to report on the methods for their elimination. The consolidated statements will reflect transactions of the consolidated group with outsiders or third parties. The premise underlying consolidated statements is that the group in the consolidation will be represented as if it were one individual unit. To arrive at this objective all intercompany transactions are eliminated and a picture of the group is presented in relation to outsiders.

The intercompany transactions and eliminations discussed in this report are the following:

1. Intercompany Interest, Rent, Fees, Bonds, etc.
2. Intercompany Bad Debts.
3. Intercompany Sales of Assets.
4. Intercompany Sales of Merchandise.
5. Intercompany Sales of Fixed Assets.
6. Intercompany Dividends.
7. Minority Interest in Earnings.

With the elimination of intercompany transactions the consolidated statements reflect the several companies as a single entity and thus offers the needed information requested by management and stockholders of the parent or dominant company.

The following general principles should be kept in mind

whenever dealing with consolidated statements:

1. Consolidated statements should be prepared for use of management, investors and other interested groups.

2. Consolidated statements are never a satisfactory substitute for individual reports of parent and subsidiaries. They should be viewed as a supplement to the regular reports.

3. Relationships shown by consolidated statements should not be used to reflect the financial position of individual companies.

When control is exercised over subsidiaries by a parent company, it is desirable to show these companies not as legal entities, but as if they were operating as one entity. This is accomplished by consolidating the financial activities of these companies into one set of statements. The consolidated statements will reflect the activities as if it were one and only one economic entity.